

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE**
45 Fremont Street
San Francisco, CA 94105

RH03029826

June 2, 2006

**Title 10
Proposed Revisions to Sections 2632.5, 2632.8 and 2632.11
Optional Automobile Insurance Rating Factors**

Summary and Response to Volume 11 Comments Received During 45-day Comment
Period

Responses to Common Comments:

1.1: Common Comments:

- Rates should be cost-based / substantially related to the risk of loss
- A driver's location (zip code) should be a critical factor in calculating insurance rates
- Drivers in rural regions of the state should not be forced to subsidize the rates for drivers in urban regions of the state.
- The proposed regulations will result in arbitrary rates because of the act of pumping and tempering, the resulting cross-subsidies, etc.

Response:

The Commissioner's regulations continue to permit a driver's location to be an important factor in setting insurance rates. While the proposed regulations preserve the importance of location in setting insurance rates, however, Proposition 103 provides that the factors which determine a driver's rates should be weighted in a specific order of importance. The proposed regulations will implement the weight ordering requirement of Proposition 103, which is codified in Insurance Code section 1861.02(a). The ballot pamphlet to Proposition 103 promised, in part, that "103 forces insurance companies to base your rates on your driving record first, rather than on where you live. That means good drivers throughout the state will pay less than they do now, while bad drivers will pay more." The ballot pamphlet also establishes that "In general, the measure requires that rates and premiums for automobile insurance be determined on the basis of the insured person's driving record, miles driven and number of years of driving experience." Finally, in the clearest possible terms, section 1 of Proposition 103 declares under the heading "Findings and Declaration" that "automobile insurance rates shall be determined primarily by a driver's safety record and mileage driven." To the extent that the cost of insurance may increase for some low income drivers and may affect businesses in rural or urban parts of the state, the increase will be determined primarily by the driver's safety record, mileage driven and years of driving experience, as Proposition 103 intended.

While some commentators believe that territory is the most important characteristic for determining the likelihood of an accident, there are other equally important, if not more important considerations which insurers often neglect under the existing regulations. Driving safety record, for example, is a very strong predictor of the risk of loss for an accident. Similarly, annual mileage driven bears a strong correlation to the risk of loss for an accident. The Department commonly observes instances where insurers do not collect meaningful data regarding the correlation between some of the mandatory factors and the risk of loss. One rating factor where insurer data is lacking is the mandatory factor of annual mileage driven. By way of example, the Commissioner has observed that one insurer arbitrarily places insurers into one of merely two categories: drivers that drive less than 7,500 miles per year and drivers who drive more than 7,500 drivers per year. Other examples show similar neglect for data collection regarding the mandatory factors. The existing regulations do not encourage insurers to develop better data collection for the mandatory rating factors, because they allow insurers to fall back on the crutch of territory for auto rating. The proposed regulations will stimulate insurers to conduct better data collection for mileage and driving safety record. This, in turn, will enhance the relationship to the risk of loss between those rating factors and the rates developed under the proposed regulations.

This comment contends that unlike the existing regulations, the proposed regulations will not be cost based and/or substantially related to the risk of loss.

The Court in *Spanish Speaking Citizens' Foundation v. Low* concluded that the language in Insurance Code section 1861.02(a)(4) which requires optional factors to be "substantially related to the risk of loss" also requires that the mandatory factors, and their order of importance must be substantially related to the risk of loss. The Commissioner notes, however, that Insurance Code section 1861.02(a)(4) expressly makes reference to the optional factors alone. Indeed, the Commissioner believes that Proposition 103 sought to bring fairness to automobile insurance rates, in part, by requiring the mandatory factors of driving safety record, annual miles driven and years of driving experience to assume greater weight than the optional factors irrespective of the mandatory factors' relationship to the risk of loss. While the Commissioner disagrees with the Court's interpretation of Insurance Code section 1861.02(a)(4) and the meaning of "substantially related to the risk of loss", the Commissioner recognizes that the *Spanish Speaking* decision represents the current state of the law, and his response takes into account the Court's interpretation in *Spanish Speaking*.

Notwithstanding the Commissioner's interpretation of Insurance Code section 1861.02(a)(4), the *Spanish Speaking* Court determined that for purposes of the weight ordering mandate, "interpretations that preserve a substantial relationship between premiums and the risk of loss ... are [] to be favored over those that would produce arbitrary rates." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1227.) The commentator contends that the existing regulations are substantially related to the risk of loss, but that the proposed regulations are not and therefore are invalid. The fundamental assumption here is that the present rate regulations ensure cost-based rating. This assumption is demonstrably incorrect.

First, Proposition 103 as well as other laws reflect the voters' and Legislature's intent that public policy objectives must often prevail over considerations of cost-based pricing. For example, many insurers contend that a policyholder's lack of a history of prior insurance bears a strong correlation to the risk of an automobile accident. Despite insurers' preference for using the absence of prior insurance as a rating factor, Insurance Code section 1861.02(c) prohibits its use. (See, e.g., *Foundation for Taxpayer and Consumer Rights, et al. v. Garamendi* (2005) 132 Cal. App. 4th 1354.) Other examples of laws which require public policy to take precedence over an argument of cost-based pricing abound. (See, e.g. Ins. Code section 11628 & 679.71 [sex, race, color, religion, national origin, or ancestry cannot by itself constitute a risk for which a higher rate may be charged].) Directly at issue, Insurance Code section 1861.02 requires that automobile rates be determined by applying "in decreasing order of importance" the mandatory factors of driving safety record, annual mileage driven and years of driving experience, followed by any optional factors adopted by the Commissioner. Thus, concerns about cost-based pricing and the relationship to risk of loss often must yield to greater concerns of public policy, as reflected in the weight ordering requirements mandated by section 1861.02(a).

Moreover, the Department has observed numerous examples of rates which are not cost-based under the existing regulations, both within the course of this rulemaking proceeding as well as during its review of rate filings submitted to the Department. The Department's Rate Filing Branch commonly receives rate filings from insurers under the current regulatory system in which the insurers select rate assignments that do not reflect the cost of providing the insurance. For example, although an insurer's loss experience might require an indicated rate relativity for a particular zip code for a cost-based rate, insurers commonly select different rate relativities which markedly deviate from the indicated rate relativity.

While the existing regulations do not result in rates that are purely cost-based, the Court in *Spanish Speaking Citizens* concluded that regulations which "preserve a substantial relationship between premiums and the risk of loss ... [are] to be favored over those that would produce arbitrary rates." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1227.) The proposed regulations, like the existing regulations, do not reflect rates which are in lockstep with a given insurer's loss experience. This situation exists not only because Proposition 103 dictates that some public policy objectives must often override the relationship to the risk of loss, but also because insurers often prefer to select rates which are different from the insurer's loss experience. Nevertheless, the proposed regulations, like the existing regulations, do preserve a substantial relationship between premiums and the risk of loss, and therefore cannot be considered arbitrary or contrary to Insurance Code sections 1861.02(a) and 1861.05.

Similarly, some commentators contend that rating factors which are enhanced or diminished (i.e. – "pumped" or "tempered") to bring the factors into the appropriate weight order are not cost-based and therefore not substantially related to the risk of loss. Under the existing regulations, however, the Department has observed instances of rate

filings in which insurers "pump" the mandatory factor of years driving experience, so that they can increase the influence of zip code on an insured's rate. Indeed, State Farm's comments regarding this rulemaking proceeding recognize that the existing regulations could require pumping or tempering in some cases. Just as the Department recognizes that public policy objectives may take precedence over cost-based rating, the Department recognizes that rates can still be substantially related to the risk of loss despite the fact that some rating factors are pumped or tempered as necessary to bring the rating factors into the correct weight order required by Insurance Code section 1861.02.

Because the proposed regulations ensure that zip code (territory) may be as high as the fourth-most important factor in calculating an insured's premium, rates will still be substantially related to the loss costs associated with a particular region of the state. The Commissioner's proposed regulations achieve the most appropriate balance among the objectives of Proposition 103. Unlike the existing regulations, the proposed regulations ensure that rates will be determined primarily by driving safety record and mileage driven, while still permitting other optional rating factors with a substantial relationship to the risk of loss to have a significant influence on premiums.

1.2: Common Comments:

- The existing regulations produce lower premiums for more good drivers than other alternatives.
- The proposed regulations will raise rates for good drivers in rural regions of the state.
- The proposed regulations will raise rates for low income drivers in rural regions of the state.

Response:

While the Court of Appeal in *Spanish Speaking Citizens v. Low* concluded that the current regulations are lawful, the Court also acknowledged that a method identical to the Commissioner's proposed regulations may also represent a permissible interpretation of Proposition 103. To the extent that the commentator suggests that the current regulatory system produces lower premiums for more good drivers, the Commissioner disagrees, as he has observed substantial evidence to the contrary. Indeed, because the proposed regulations ensure that how you drive will be more important than where you live, it is axiomatic that more good drivers will experience rate decreases under the proposed regulations than under the current regulatory system.

1.3 Common Comments:

- The proposed regulations should be fair for all regions of the state and not just urban regions of the state.
- The Commissioner's proposed regulations ignore the impact upon rural and suburban regions of the state.

Response:

The Commissioner has considered the impact upon both rural and urban drivers in the state. After receiving a petition for rulemaking in May of 2003, the Commissioner personally attended seven informational meetings in regions of the state ranging from Fresno and Chico to Los Angeles and Oakland to discuss the potential impact of the proposed regulations upon rates for urban and rural regions of the state. The Commissioner observed numerous instances – in rural as well as urban locations – where drivers with identical characteristics would pay unjustifiably different premiums simply because they live in the "wrong" zip code.

For example, the Commissioner has observed substantial variations in premium not only for consumers living within just a few miles of each other, but even for neighbors who live in adjoining zip codes. In fact, the differentials in territory relativities between adjacent zip code pairs for some companies do not closely follow the patterns of the industry wide pure premium data. In looking for examples of arbitrary rates and premiums, one need look no further than the premiums established under the existing regulations. Examples such as these demonstrate that the existing regulations are neither purely cost-based nor consistent with Proposition 103's distaste for zip code rating. The Commissioner's proposed regulations will prevent similar disparity between zip codes in the future, by requiring insurers to give more consideration to how you drive rather than where you live. Not only does this approach make sense, it is the approach that the Proposition 103 ballot pamphlet promised to the voters.

1.4 Common Comments:

- According to studies performed by Robert Downer and Mercer Actuarial Consulting, Inc., the proposed regulations will result in an XX% increase for XX drivers. Rates will increase for 52 out of 58 counties.

Response:

At the outset, it is important to point out that any projection of premium that a particular consumer or even a particular region of the state may pay due to the proposed regulations is a matter of substantial speculation. The Commissioner's proposed regulations provide a significant degree of discretion to insurers to decide upon the most prudent manner for implementing the proposed regulations. This discretion exists, in part, because the proposed regulations permit insurers to use any combination of pumping or tempering of rating factors necessary to achieve the order of importance required by section 1861.02(a). Because different insurers will use different rating factors and different methods for achieving compliance with the proposed regulations, it would be virtually impossible to perform a study which would show the precise effect that the proposed regulations will have upon premiums for Californians statewide. Generally speaking, the Commissioner's proposed regulations grant an insurer broad discretion to implement the proposed regulations, so long as a given insurer's rates assign the greatest weight to 1) driving safety record, followed by 2) annual miles driven, followed by 3) years of driving experience, followed by 4) any optional rating factors, weighted individually. While some studies have projected an average rate change for a particular region of the state, the impact of such projection upon a particular consumer will vary significantly due to the unique characteristics of each consumer. Additionally, to date, no study has explored all

of the possible methods by which any given insurer may choose to comply with the proposed regulations. For each of these reasons and others, any comment which suggests that premiums will raise or lower for a particular region of the state by an average of X% is purely speculative and fails to ignore the unique nature of each driver's characteristics as well as the unique manner in which each insurer will choose to comply with the regulations.

This comment includes a figure that suggests a particular County's drivers will receive rate increases of a particular size due to the Commissioner's regulations. To the extent that this comment is referring to the Mercer Actuarial Consulting, Inc. study, the figure appears to have been derived from "Instruction set 3" which was designed to replicate the results of a study performed by Robert Downer. As explained below, the Downer study does not represent an accurate portrayal of the impact of the proposed regulations on Californians' auto rates. Instruction sets 1 and 2, by comparison, showed substantially different and more favorable premium changes for good drivers in all regions of the state.

To the extent that this figure comes from a study produced by Robert Downer, it is important to note that the Downer study produced substantially flawed results which do not represent a reasonable projection of the way in which insurers will comply with the proposed regulations. The Downer study chose to diminish the effect of (i.e. – "temper") any optional factor that was greater than the factor of years of driving experience. At the same time, the Downer study did not permit the possibility of increasing the effect of (i.e. – "pumping") other factors, or a combination of diminishing some factors and increasing others. The proposed regulations, like the existing regulations, permit any insurer to pump or temper any rating factor as necessary in order to achieve compliance. This procedure was not implemented by Mr. Downer's study and directly resulted in the substantial premium shifting projected by Mr. Downer. The Downer study, in short, does not accurately reflect the manner in which insurers will implement the proposed regulations. Because the findings in the Downer study do not accurately reflect the manner in which insurers may implement the proposed regulations, they are irrelevant and consequently have been rejected by the Commissioner.

Mr. Downer's comments regarding the proposed regulations include a new study which he apparently performed in February of 2006. For the reasons described above, this study, like the Mercer data and Mr. Downer's previous study, are constrained by the same limitations and to a reasonable degree of certainty will not reflect the methods of pumping and tempering that individual insurers will use to comply with the proposed regulations.

1.5 Common Comments:

- **Seniors living in rural regions of the state should not be penalized by the proposed regulations.**

Response:

Proposition 103 provides that the number of years of driving experience must be the third most important rating factor, in terms of the weight given to each rating factor. Because

different insurers use differing characteristics to rate drivers according to their age and driving experience, whether a given consumer's age will result in a higher or lower auto insurance rate under the proposed regulations will largely depend upon which insurance company the consumer selects for coverage. Consumers who compare prices before purchasing automobile insurance may find that they will qualify for a lower insurance rate.

1.6 Common Comments:

- **The Downer Study and Instruction Set #3 from the Mercer Study suggest rates in my county will increase by X%.**

Response:

As with many of the figures cited in similar comments submitted to the Department, the figures cited in this comment do not bear a reasonable relationship to the likely rate impact of the proposed regulations. The percentage increase in rates described by this commenter appears to be based upon the results of the Downer study and the related results of Instruction set 3 from the Mercer Study. As explained in Response 1.4 above, the Downer study produced substantially flawed results, because Mr. Downer's analysis simply tempered the weight of the optional rating factors, without allowing for the pumping of mandatory factors. In other words, Mr. Downer's analysis sought to place the burden of the entire shift in a consumer's rate on territory without adjusting other rating factors to affect the rate. The Commissioner's regulations, however, do not condone such an approach. In fact, the Commissioner's regulations envision that insurers will do more than merely temper those factors, such as territory, which are weighted too heavily under Proposition 103. The Commissioner's regulations also seek to force insurers to pump, i.e. - give greater consideration to factors such as years licensed, annual mileage driven and driving safety record – factors that insurers have traditionally placed less emphasis on, when compared to the emphasis placed upon territory.

1.7 Common Comments:

- **The proposed regulations will produce rates which are not actuarially sound.**
- **The proposed regulations, by creating cross-subsidies, violate actuarial standards of practice.**
- **The proposed regulations are unfairly discriminatory or are not substantially related to the risk of loss because they are not actuarially sound.**

Response: As compared to the existing regulations, the Commissioner's proposed regulations represent the lawful interpretation of Proposition 103. Insurance Code section 1861.02 requires that every optional factor, such as territory, be given less weight than driving safety record, annual miles driven or years of driving experience. The American Academy of Actuaries' Statement of Principles for Risk Classification provides that actuarial standards must yield to social acceptability guidelines, including applicable law. (American Academy of Actuaries, Risk Classification Statement of Principles, p. 14, para. H.) Because optional factors must be given less weight than under the proposed

regulations in order to ensure that the mandatory factors are most important as section 1861.02 requires, the resulting rate cannot be considered actuarially unsound on this basis. Moreover, the Commissioner has observed substantial evidence to suggest that rates under the current regulatory system are often not tied to the risk of loss. Indeed, whether territory, gender, marital status or a multiple car discount are entitled to the significant weight they are given by many insurers under the existing regulations is a subject of considerable disagreement within the insurance ratemaking community.

1.8 Common Comments:

- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because they allow for pumping and tempering.**
- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because they create rates which are not based on the cost of providing insurance.**
- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because rates which are not cost-based are arbitrary.**

Response: Although the Court in *Spanish Speaking Citizens* considered the standards of Proposition 103 and concluded that rates which deviated from cost-based pricing would violate Proposition 103's prohibition against arbitrary rates, the Court also conceded that "there may be no one single correct interpretation" of Proposition 103's competing requirements. (*Spanish Speaking Citizens' Foundation v. Low* 85 Cal.App.4th 1179, 1231.) The Court also acknowledged that the existing regulations do not ensure that rates will be determined primarily by driving safety record and mileage driven, as the ballot pamphlet to Proposition 103 intended. (*Spanish Speaking Citizens* 85 Cal.App.4th at 1237-38.) Recognizing the competing goals of Proposition 103, and the fact that rates are not determined primarily by driving safety record and mileage driven, the Court noted that an interpretation of Proposition 103 identical to the interpretation set forth in the Commissioner's proposed regulations, "may be a permissible interpretation of [section 1861.02]." (*Spanish Speaking Citizens* 85 Cal.App.4th at 1239.)

1.9 Common Comments:

- **The proposed regulations do not account for the likelihood of theft in urban areas versus rural areas**
- **The proposed regulations do not account for the likelihood of vandalism claims in urban areas versus rural areas.**

Response:

Claims for vehicle theft or vandalism generally fall under an insurance policy's comprehensive coverage. Claims under that coverage may have limited correlation to the mandatory rating factors. To the extent that comprehensive coverage bears less of a relationship to the mandatory factors of driving safety record, mileage driven and years of driving experience, the Commissioner has revised the regulations to account for the unique concerns raised by comprehensive coverage. Title 10 California Code of Regulations section 2632.8(a) permits an insurer to combine comprehensive coverage

with collision coverage to enhance the proposed regulations' substantial relationship to the risk of loss. The regulatory change which will allow such combination will comply with Proposition 103's weight ordering requirements insofar as comprehensive coverage and collision coverage represent a policy "combination thereof" as described in section 660(a).

Volume 11, Tab No. 13:

Commentator: Milo Pearson & Christian Rataj, on behalf of the Pacific Association of Domestic Insurance Companies and the National Association of Mutual Insurance Companies

Date of Comment: February 24, 2006

Type of Comment: Written

Summary of Comment (page 1):

These pages provide introductory information about the commentators, and a description of the relevant background of the commentators' companies.

Response to Comment:

Because these pages are not specifically directed at the agency's proposed action or to the procedures followed by the agency in proposing or adopting the action, no response is necessary here.

Summary of Comment (page 2):

The proposed regulations will increase rates for a majority of drivers (over 60%) in the State. Rates will increase for 52 out of 58 counties and the rate increases will be imposed primarily upon suburban and rural areas of the state. One of the commentators' member companies estimates that insurance rates will increase for 78% of that insurer's policyholders.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.4

See Response to Common Comment 1.6

Summary of Comment (page 2-3):

While the existing regulations are generally cost based, the proposed regulations are not. By artificially reducing the importance of territory for auto rating purposes, the proposed regulations will result in an inappropriate subsidization of urban rates at the expense of rural drivers. While artificial pumping and tempering of a rate will reduce geographic premium disruption, it may cause unintended consequences such as increasing the rates for commuters in this State. The proposed regulations are not cost based and to the

extent that the proposed regulations permit insurers to pump and temper rating factors, this will move the State even further away from cost based ratemaking law.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

Summary of Comment (page 3):

The proposed regulations will move away from cost-based pricing and will generally result in urban drivers paying inadequate rates. Similarly, the proposed regulations will result in forcing rural drivers to pay excessive rates. These rates will violate Insurance Code section 1861.05 and the prohibition against excessive or inadequate rates. How will the Department be able to review a rate filing or a class plan filing, when the distribution of a rate is artificial?

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

See Response to Common Comment 1.8

Additional Response:

The Department's process for reviewing rate filings and class plan filings will be similar to the process under the existing regulations. Because, under the existing regulations, insurers often do not select cost based relativities, the Department reviews the extent to which the insurer's resulting rate is either excessive or inadequate. Similarly, under the proposed regulations, the Department will continue to evaluate rate and class plan filings in order to ensure that the resulting rates are consistent with existing law.

Summary of Comment (page 3-4):

The proposed regulations will create affordability issues for rural and suburban drivers. Many rural drivers will not be able to afford the rate increases and the proposed regulations will simply shift the affordability problems for poor urban drivers to poor rural drivers. The shifting of affordability is neither appropriate nor justifiable.

Response to Comment:

The purpose of the proposed changes to the regulations is to implement the weight ordering requirement of Proposition 103. Thus, under the proposed regulations, an individual's driving safety record, annual mileage driven and years of driving experience must be the three most important factors which make up a policyholder's automobile insurance rate. While a driver's location may still be given substantial importance, that factor cannot weigh more than the factors described above. The proposed regulations will affect low-income communities differently. Where a person lives will have less influence on an insurance rate than how a person drives. This system of rating is the

system that the majority of California decided was most equitable, when the voters enacted Proposition 103 in 1988.

Summary of Comment (page 4):

The proposed regulations are in conflict with principles of insurance underwriting. Insurers need the freedom to underwrite and weigh a particular insured's potential risk of loss. Actuarial studies have repeatedly demonstrated that automobile accidents and vehicle thefts occur more frequently and with greater severity in urban areas, but the proposed regulations will hinder the ability of insurers to correlate insurance rates to the risk of loss.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

Additional Response:

Insurers' ability to underwrite has always been constrained by public policy goals, as reflected in applicable law. Proposition 103 is yet another example of this legal constraint, and it sets forth the three factors which must be the most important factors for automobile insurance rating. The rates which will result from the proposed regulations will continue to be cost based and substantially related to the risk of loss. Unlike the existing regulations, however, the proposed regulations will also give meaning to Proposition 103's requirement that "automobile insurance rates shall be determined primarily by a driver's safety record and mileage driven."

Summary of Comment (page 4):

The Commissioner should consider additional study of the impact to California drivers of the proposed regulations and to carefully consider alternative measures that will reduce or eliminate rate shifting and maintain actuarially sound cost based rates.

Response to Comment:

The proposed regulations have been the subject of extensive study. There is no study that could be performed which could capture the many different combinations of pumping and tempering that individual insurers may elect to utilize, and subsequently adjust in future class plan filings, in order to comply with the proposed regulations. Moreover, while the Commissioner has carefully considered alternatives to the proposed regulations, he has concluded that there is no alternative to the proposed regulations that would be as effective and less burdensome in carrying out the requirements of Proposition 103 than the proposed regulations.